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Date:

September 19, 2007

Trust =

Separate =
QSSTs

X =

A =

Year 1 =

Year 2 =

Dear :

This letter responds to a letter dated October 16, 2006, and subsequent correspondence submitted on behalf of Trust by its authorized representative, requesting certain rulings under §§ 1001 and 1361 of the Internal Revenue Code.

The information submitted states that in Year 1, A established Trust, an irrevocable trust for the benefit of A's descendants. Trust was funded with cash, and the trustees used the cash to buy stock in X, an S corporation. The terms of Trust permit Trust to make either electing small business trust (ESBT) or qualified subchapter

S trust (QSST) elections, which would be necessary for Trust to become an eligible S corporation shareholder. Trust provides for distinct funding and distribution requirements according to the type of election that is made.

Article 1 of Trust provides for the distribution of income and principal of Trust if an ESBT election is made. Article 1 also applies to all trust assets other than stock in the S corporation. Under this article, a single trust would be established with A's descendants as potential current beneficiaries of income and principal distributions.

Article 2 of Trust governs distributions of income and principal if a QSST election is made. Under this article, separate trusts are established for the benefit of A's descendants. The income and principal of each trust is to be distributed at the discretion of the trustee. Trust income must be distributed at least annually if necessary to preserve S corporation status.

Whenever the distribution of income is not made mandatory, §§ 1.1 and 2.1.A. of Trust gives the trustees sole discretion to determine the amounts and timing of income and principal.

Section 5.6 of Trust generally authorizes the trustees to amend the trust agreement, as necessary, to comply with the provisions of § 1361. Upon the issuance of a favorable private letter ruling, § 5.6 of the Trust will be amended to clarify that the trustees are authorized to make any election, and make any changes to Trust as necessary, to convert any separate share of Trust with respect for which a QSST election has been made into a separate trust with respect for which an ESBT election will be made.

After initial funding of Trust in Year 1, four separate trusts (Separate QSSTs) were created for the benefit of A's children pursuant to the terms of Article 2, and QSST elections were timely made for each. It is represented that each of Separate QSSTs met the requirements necessary to be treated as a QSST.

In Year 2, the trustees determined that, consistent with A's original intent, it would be prudent to convert Trust from separate QSSTs into separate ESBTs. To accomplish this conversion, the trustees would transfer the property from the Separate QSSTs into corresponding Separate ESBTs. All property to be held by Separate ESBTs would be contributed directly from Separate QSSTs and would not be acquired by purchase.

RULING 1

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder. Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation.

Section 1361(d)(1) provides that in the case of a QSST for which a beneficiary makes an election under § 1361(d)(2), (A) the trust is treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of the trust shall be treated as the owner of that portion of the trust that consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made. Section 1361(d)(2)(A) provides that a beneficiary of a QSST may elect to have § 1361(d)(1) apply.

Section 1361(d)(3) provides that for purposes of § 1361(d), the term "QSST" means a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only one beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and (B) all of the income (within the meaning of § 643(b)) of which is distributed currently to one individual who is a citizen or resident of the United States.

Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), an ESBT means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a PCB, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust. Section 1361(e)(1)(B)(i) provides that the term "ESBT" shall not include any QSST (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust.

Section 1.1361-1(j)(11) of the Income Tax Regulations provides that a QSST election may be revoked only with the consent of the Commissioner. Section 1.1361-

1(j)(12) grants automatic consent for a trust that seeks to convert from a QSST to an ESBT if certain requirements are met.

Based solely on the facts and representations submitted, we conclude that Separate QSSTs will be eligible for consent to revoke their QSST elections and convert to separate ESBTs, effective as of the creation of the Separate ESBTs. Each Separate ESBT must file an ESBT election with the service center where X files its income tax return. A copy of this letter should be attached to such election.

RULING 2

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in §1011 for determining gain, and the loss is the excess of the adjusted basis provided in §1011 for determining loss over the amount realized. Under §1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under §1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." *Id.* at 565. In Cottage Savings, the Court held that mortgage loans made different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. *Id.* at 566. In defining what constitutes a "material difference" for purposes of §1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. *Id.* at 564-65.

In the present case, the conversion of Separate QSSTs into Separate ESBTs will result in a transfer of property. Under Cottage Savings, it must be determined whether this transfer of property will cause a "material" change in the beneficiaries' legal rights and entitlements.

Under Cottage Savings, a beneficiary's legal entitlements are "materially" different if they are different in kind or extent. In the trust context, each beneficiary is entitled to property only in accordance with the terms of the trust that are applicable at a

given time. In the instant case, Trust permits amendments to be made that potentially alter the distribution possibilities for the beneficiaries. As such, these changes are part of the legal entitlements bestowed upon the beneficiaries when Trust was created.

It is represented that the proposed conversion will be authorized under the terms of Trust. Accordingly, the proposed conversion will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized by the beneficiaries or the trusts on the merger for purposes of § 1001.

Based solely on the facts and representations submitted, we conclude that the proposed conversion of Separate QSSTs into corresponding Separate ESBTs will not constitute a gain or loss realized under § 1001.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code.

This ruling is directed only to the taxpayer that requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file, a copy of this letter is being sent to Trust's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes